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THE TAX STATUS OF CAPITAL GAINS IN CANADA

by

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The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies for acceptance, a thesis entitled: The Tax Status of Capital Gains in Canada, submitted by Harold Owen Ricker, in partial fulfilment of the requirements for the degree of Master of Arts.

ABSTRACT

This thesis is concerned with determining the place of capital gains in the Canadian income tax structure. In the British tradition, accretions to capital are theoretically not taxed. In practice, it is the scope of the definition accorded them which determines the extent to which this is true.

Since capital gains are treated in the Canadian Income Tax Act as a residual, it is the definition of income to which we must look. The definition in the present Act is a very vague and uncertain one, and thus much interpretative work has been left to the courts. The portion of the Act with which we are most concerned in this thesis is section 139 (1) (a) which brings an "adventure in the nature of trade" under taxation. This term, which was borrowed from Britain and was first used in 1948, has proven to be a perplexing one. It is apparent from an examination of many of the cases which have arisen concerning its meaning that it is a difficult concept to define. While a number of tests have been developed to determine its meaning, in the final analysis each case is decided on the basis of its own facts with the tests serving merely as a rough guide.

There are many different views, too, regarding the economic considerations involved in the taxation of capital gains. The problem of whether or not such gains should be taxed is far from clear-cut and an entirely satisfactory compromise seems difficult to attain.

The conclusion reached is that at present in Canada capital gains occupy an extremely uncertain place in the tax structure. While it may never be possible to reach a definition of capital gains which will provide complete certainty and yet be satisfactory from an economic standpoint, much could be done to improve the present Act. The solution may have to be a compromise between certainty and other economic considerations.

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CHAPTER I

INTRODUCTION

The income tax has become a well-established and accepted part of the tax systems of many countries. A fundamental problem in all such countries is that of establishing a definition of income which will prove satisfactory from the standpoint of equity, administrative efficiency and other economic considerations. Canadian experience in this regard has not proved different from that of other nations.

Canada's first taxing statute, the Income War Tax Act of 1917,¹ contained a long specific comprehensive definition of income, with an attempt being made, it seemed, to cover virtually every possible situation that could arise.² In contrast to this, the definition in Section 3 of the 1948 Income Tax Act³ is very brief, general and extremely vague. It reads:

3. The income of a taxpayer for a taxation year for the purposes of this Part is his income for the year from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from all

¹ 7-8 Geo. V, c. 28.

² We will look at this definition and its place in the development of the income concept in Canada in Chapter 2.

³ R.S.C. 1952, c. 148.

- (a) businesses
- (b) property, and
- (c) offices and employments

In the light of this definition it is not surprising that much of the work of determining what taxable income is has fallen to the courts. The distinction between capital and income receipts and payments has provided a fruitful source of litigation in the period since 1948.

It shall be our task here to examine a number of judicial decisions in this area and to attempt to extract therefrom some general principles. It may then prove possible, in the light of economic theory, to suggest possible changes which would put these legal principles on a more solid economic footing.

It will, however, be impossible to attempt a complete discussion of the definition of income, even dealing strictly with the Canadian situation. The research involved in such an examination is much beyond that contemplated in this study. It will be necessary to limit the topic under consideration to but a few aspects of the larger problem.

The last detailed study of the income concept in Canada was undertaken by Professor F. E. La Brie in a book published in 1953,⁴ but at the time few cases had been heard under the new Act. Thus it deals largely with the Income War Tax Act with its comprehensive income definition. Even updating his work would be a major task, because of the large number of cases arising under the 1948 Act.

Our concern will be with the distinction between income and so-

⁴F. E. La Brie, The Meaning of Income in the Law of Income Tax (Toronto: University of Toronto Press, 1953).

called "capital gains." What are capital gains? Seltzer suggests that they are "the profits realized from increases in the market value of any assets that are not part of the owner's stock-in-trade or that he does not regularly offer for sale."⁵

In the simplest economic sense, according to Seltzer, they "are best regarded as unforeseen increases in the real value of a man's previously existing property, not directly attributable to his efforts, intelligence, capital, or risk-taking."⁶ Postponing further discussion of the nature of capital gains to a later chapter, we must relate these definitions to Section 3 of the Act in an effort to limit the topic more precisely.

It is quite readily apparent that we are concerned with income in a gross, rather than net, sense; the interesting area of deductions is thus ruled out. Similarly, we will not be concerned with income from offices or employments, as such income is normally related to one's efforts and does not usually involve assets. The types of receipts normally falling under such a heading would be wages, salaries and the like. Also, we must rule out income from property. In its usual sense, this refers to rents, royalties and so on. While there may be distinctions to be made between income and capital in these areas, they are not the ones normally associated with the concept of "capital gains."

⁵L. H. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (New York: National Bureau of Economic Research, 1951), p. 3.

⁶Ibid., p. 53. This is Pigou's definition of windfalls in Public Finance (3rd ed.; London: Macmillan Co., 1949), p. 156.

We are left with Section 3 (a), income from business. It is in this area that the majority of cases usually dealt with under the heading of "capital gains cases" arise.⁷

Gains from business in its popular sense are of little concern to us here. However, the Act goes further to bring certain other transactions within the meaning of business for tax purposes. It is these in which we will be interested.

In Section 4 we find:

Subject to the other provisions of this Part, income for a taxation year from a business . . . is the profit therefrom for the year.

More particularly we are concerned with Section 139 (1) which reads:

In this Act . . .

(a) business includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever, and includes an adventure or concern in the nature of trade.

The exact meaning of the expression "an adventure or concern in the nature of trade" has caused a good deal of perplexity in Canadian courts since it first appeared in the 1948 Act and it is with some of the tests which have been devised to determine meaning that we will mainly deal.

⁷ See, for example, David R. Sinclair, "An Analysis of Capital Gains Cases," Canadian Chartered Accountant, LXXVIII (February, 1961), p. 107; B. B. Shinder, "The Taxability of Capital Gains in Canada," Faculty of Law Review, University of Toronto, XIX (April, 1961), p. 87; J. Barbeau, "Tax Treatment of Capital Gains," Canadian Bar Journal, II (1959), p. 144; and Irving J. Goffman, "The Tax Treatment of Capital Gains in Canada," National Tax Journal, XIV (December, 1961), p. 356.

The topic has acquired added interest with the appointment of a Royal Commission on Taxation in 1962, although the taxation of capital gains has been a topic of debate in Canada for some time.⁸ Jacques Barbeau, a Vancouver lawyer and former Director of Research of the Canadian Tax Foundation, suggested to the 1962 Conference of the Foundation that the matter will undoubtedly be considered by the Commission and pointed out that "before deciding to tax or not to tax capital gains it should first be ascertained what would, under present conditions, qualify as a taxable capital gain."⁹

If we are successful in determining the latter, then it should be possible to ascertain whether a change in tax treatment would have, on balance, a beneficial or a harmful effect on the Canadian economy.

In discussing the problem we will first look briefly at the development of the income concept in Canada, particularly with regard to the capital gains area. An attempt will be made to assess the nature and extent of British and American influence in this area, both on the statutes and on the judicial decisions. This will be the task of Chapter Two.

⁸For example in his budget address in 1949, The Honorable Douglas Abbott, the Minister of Finance of the day, declared, evidently to allay apprehension on the point, "It is not the policy of this government to tax capital gains." House of Commons, Debates (Ottawa, May 28, 1950, p. 1217), quoted in Goffman, op. cit., p. 361. See also: Canadian Tax Foundation, Proceedings of Thirteenth Annual Tax Conference (Toronto, 1959) pp. 9-21 for further discussion of the problem. Numerous other examples could be cited to show the widespread interest which the problem has attracted during the past few years.

⁹Canadian Tax Foundation, Proceedings of Sixteenth Annual Tax Conference (Toronto, 1962), p. 76.

The third chapter will be concerned with the case law which has arisen in Canada in this area. It will involve a detailed examination of a number of cases, particularly ones of recent origin and an attempt to classify the cases in an effort to determine general principles. It is hoped that some light will thereby be thrown on the meaning of the expression "an adventure or concern in the nature of trade."

Chapter Four will be devoted to discussion of the economic considerations involved in the taxation of capital gains and the arguments based on economic theory both for and against such taxation. An attempt will be made to determine more precisely the nature of capital gains and consideration will be given to the probable effects on an economy of a capital gains tax in terms of equity, resource allocation, income distribution and economic stability. The chapter will conclude with a brief discussion of the administrative problems involved in such taxation.

In the concluding chapter, an attempt will be made to determine the present tax status of capital gains in Canada, and the desirability of a change in this status will be considered.

CHAPTER II

THE PLACE OF CAPITAL GAINS IN BRITISH, AMERICAN AND EARLY CANADIAN TAXATION

Introduction

Several countries have had a longer experience with income taxation than Canada.¹ Thus, Canadian lawmakers had a considerable backlog of experience on which to draw at the time the first Canadian taxing statute was drafted in 1917. However, as with most other aspects of Canadian law, British influence was extremely great, although in the tax area the United States experience was also of some importance.

In this chapter we shall examine briefly the nature and extent of the influence of British and American taxing experience on early Canadian practice. We shall then look at the provisions of the Income War Tax Act and refer to some of the cases arising under it. Finally, we shall consider the changes brought about by the 1948 Income Tax Act, whose provisions have already been noted in Chapter I.

Britain--The "Harvest Concept"

The British concept of income, which has generally been followed

¹For example the United States first imposed an income tax in 1862; Britain had one at an even earlier date.

While, in general, Britain has continued to tax only income and not capital gains, it was from Britain that the words "adventure in the nature of trade" came. Although it might appear at first that to tax isolated gains under this guise marks a break with earlier British tradition, it should be noted that the tax falls on the gain from the "adventure," not the profit from the sale of the asset.

In recent years there appears to have been considerable agitation in Britain for the imposition of a capital gains tax. This agitation, particularly from Labour supporters, resulted in the imposition of a tax on short term "speculative" gains in 1961. It applies essentially to gains from securities purchased and sold within six months and real property held less than three years.³

Apart from this, the old tradition continues. In comparing the British situation with that in Canada, it is apparent that the two are similar in many respects. However, the British definition of income is much more explicit than its Canadian counterpart. The British income tax is imposed according to a series of five schedules classified according to source. Despite the increased precision of definition, British courts have had to decide a large number of cases on the meaning of income.

While the meaning of income and, hence, capital gain in Canada and Britain may not be identical, there is sufficient similarity between

³ For an outline of the provisions of this change see A. R. Ilersic, "The U.K. Budget, 1962," Canadian Tax Journal, X (May-June, 1962), p. 215. See also Alun G. Davies, "The Mouse That Roared," Ibid., p. 196 and A. R. Ilersic, "Taxing Speculative Gains in Britain," Ibid. (September-October, 1962), p. 312.

the two that Canadian courts have often relied on British decisions in similar Canadian situations.

In the headnote to a recent case we read, "The decisions of British courts are a safe guide in Canadian law since the Canadian definition of 'business' is no wider than that given to the word 'trade' in British legislation."⁴ The headnote continues with the warning that "it should be remembered that the British Act taxes the income from designated sources while the charge is upon income from all sources under the Canadian Act."⁵

La Brie gives a more general warning. He suggests that "care must be exercised in order to distinguish decisions based on a legal principle of general application from those founded wholly or in part on the specific requirements of the English Acts."⁶ He concludes that "a proper understanding and reasonable application of English cases in solving Canadian income tax problems must be based on a sound appreciation of the English scheme of taxation in relation to the Canadian legislation."⁷ It is questionable whether such an appreciation is present in

⁴#341 v. Minister of National Revenue, 56 Dominion Tax Cases 231 at p. 232. Minister of National Revenue will henceforth be abbreviated M.N.R., while Dominion Tax Cases will be shown DTC. It will be noted that in all DTC volumes cases decided by the Tax Appeal Board appear on pages numbered 1 to 999 while cases heard in the Exchequer or Supreme Courts appear on pages numbered 1000 or higher. Among the latter cases those decided by the Supreme Court will henceforth be specifically indicated; all others may be assumed to be Exchequer Court decisions.

⁵Ibid.

⁶La Brie, op. cit., p. 4.

⁷Ibid., p. 5.

every Canadian case in which British jurisprudence is invoked, and La Brie seems to imply⁸ that Canadian courts may have been somewhat indiscriminate in their application of British cases. As we proceed, the extent of the British influence on Canadian courts will become apparent, as will the extent to which Canadian judges have diverged from British principles.

The American Position

Seltzer suggests that the United States also inherited the "harvest concept" on income. He then enumerates three reasons why, despite this fact, Americans came to tax capital gains.⁹

Although agriculture was predominant in the early American economy, (as had been the case in Britain) land was plentiful and cheap. Since the country was new, there was no landed aristocracy which could trace title to its land back over several generations. Land thus lacked the prestige it had conveyed in Europe. Fathers did not take such pains to see that land would pass only to specified heirs, and sales were more frequent. As the country developed and grew, land values increased, often tremendously. Since business and personal mobility was high during the period of westward expansion, many of these gains were realized. The pursuit of gain became the object of many transactions, and quick and spectacular fortunes were often made.

The development of the corporation provided another means of

⁸Ibid.

⁹Canadian Tax Foundation, Report of Proceedings of Thirteenth Annual Tax Conference (Toronto, 1959), pp. 17-19.

making capital gain. By retaining a large percentage of corporate earnings (particularly in a closely held company) personal income tax could be avoided indefinitely and the value of shares would be proportionately increased. Neither the corporation tax nor the inheritance tax provided an equitable solution to the problem.

As we have seen, British thinking regarding the distinction between capital and income with respect to land was established well before the corporate form of business organization became common. The reluctance to break with tradition in Britain undoubtedly explains the fact that British thinking on capital gains arising through the use of the corporation differed from that in the United States.

Finally, Seltzer points out that one view of the purpose of the income tax is that it should "apportion the costs of government among individuals in accordance with their relative capacity to bear them."¹⁰ The idea that a capital gain represents, in many instances, an increase in a person's ability to contribute to the support of government, while not a universally held one, seems to have been accepted in the United States more so than in Britain, according to Seltzer. We must defer further discussion of this point to Chapter Four.

For these reasons, Seltzer suggests, capital gains have been included as income in the United States almost from the first imposition of income tax. A distinction is still made between capital gain and other

¹⁰
Ibid., p. 18.

income in the United States, but it is necessitated by the fact that capital gains are taxed at a lower rate than that on other income. Without making a careful study of the situation, it seems safe to conclude that the definition of income in the United States is both clearer and subject to narrower application than that in Canada. Despite this fact, the rate differential¹¹ provides a substantial amount of litigation on borderline cases.

Since the early Canadian situation closely resembled that in the United States, it appears somewhat surprising that Canadian tax law did not more closely follow that of its southern neighbor. Whether the British influence was too strong or for some other reason, the impact of American taxing practice has not been great in Canada.

Statutory Development in Canada

We turn now to an examination of the development of the Canadian income concept. As was noted earlier, the definition of income in the 1917 Income War Tax Act was a detailed one. While many of the provisions of the Act were amended over the next thirty years, the charging section remained virtually unchanged throughout. In the words of the Act, Section 3(1):

Income means the annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or finan-

¹¹ The maximum rate on capital gains is 25%, while other income is subjected to a top rate of 91%.

cial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be; and shall include the interest, dividends, or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment, and, whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source; including the income from but not the value of property acquired by gift, bequest, devise or descent; and including the income from but not the proceeds of life insurance policies paid upon the death of the person insured, or payments made or credited to the insured on life insurance endowment or annuity contracts upon the maturity of the term mentioned in the contract or upon the surrender of the contract. . . .

Goffman points out¹² that the wording was virtually as broad as that of the American statutes and was probably wide enough to justify inclusion of capital gains in the tax base. Canadian courts chose, however, to interpret it in light of British case law the few times that situations came before them. Sinclair suggests¹³ that the first important capital gains case in Canada was the Atlantic Sugar Refining case¹⁴ in 1949. Goffman¹⁵ refers to two additional cases, Anderson Logging v. The King¹⁶ and Merritt Realty Co. v. Brown.¹⁷ Regardless

¹²I. J. Goffman, "The Tax Treatment of Capital Gains in Canada," National Tax Journal, XIV (December, 1961), p. 356.

¹³David R. Sinclair, "An Analysis of Capital Gains Cases," Canadian Chartered Accountant, LXXVII (February, 1961), p. 157.

¹⁴49 DTC 602.

¹⁵I. J. Goffman, op. cit.

¹⁶[1925] S.C.R. 47.

¹⁷[1932] S.C.R. 187.

of the actual number of cases, it seems safe to conclude that under the old Act the courts had few problems of interpretation to solve.

All this changed in 1948 with the passage of the Income Tax Act, which took effect from January 1, 1949. Although there were not many cases at first, there has since been what Sinclair refers to as a "torrential flow of litigation."¹⁸ While the new Act considerably simplified appeal procedures, it is likely that the change in the definitional section has been largely responsible for the flow. The meaning of "an adventure in the nature of trade", which was first tested in 1956, has provided many of the recent decisions.

We turn now to a more detailed examination of these cases in an effort to ascertain whether any generalizations are possible regarding the meaning of the latter expression. This will occupy the next chapter.

¹⁸Sinclair, op. cit.

CHAPTER III

THE MEANING OF CAPITAL GAIN IN CANADA

Introduction

Income tax is purely a creature of statute. As with most statutes, it has often fallen to the courts to provide interpretation of certain sections of tax statutes. Because of the vague and uncertain charging section in the 1948 Canadian Income Tax Act, judicial interpretation has become an extremely important part of Canadian income tax law.

However, even judicial decisions do not always ensure future certainty. They, too, are subject to interpretation by subsequent courts; and depending on a number of factors, they may be construed as widely or narrowly as the statute itself. In some instances a decision has subsequently been applied only in a virtually identical fact situation; in other situations cases have been held to be of quite general applicability.

While it is these latter cases that will prove most useful to us here, it will be necessary to examine a number of cases of both types in order to draw any valid conclusions.

A number of tests have come into use in Canada in the attempt to distinguish capital gain from income. It is usually necessary, but seldom sufficient, for a transaction to possess at least one attribute of income to make any profit taxable. Many of the tests are British in origin and thus it will be necessary to look briefly at a few British decisions. But

we must keep in mind the previous caution against indiscriminate use of such cases.¹ Our concern in this chapter, then, will be mainly with Canadian decisions arising under the 1948 Act and only incidentally with others which may have some bearing on the subject at hand.

An Adventure in the Nature of Trade

The first Canadian case dealing with the meaning of the words "an adventure in the nature of trade" to reach the Exchequer Court was that of M.N.R. v. Taylor.² The thorough and carefully reasoned judgment of Mr. President Thorson in that case will provide us with a convenient outline for our discussion. The first part of the judgment deals at length with cases decided under the British Act up to that time. The learned President then states a number of general principles which he derives from them. He sets out five negative and two positive propositions which, he suggests, summarize the tests normally applied. However, "it is not possible to determine the limits of the ambit of the term or lay down any single criterion for deciding whether a particular transaction was an adventure of trade for the answer in each case must depend on the facts and surrounding circumstances of the case."³

On the negative side he claims:

The singleness or isolation of a transaction cannot be a test. . . . This does not mean that the isolation or singleness of a transaction has no bearing on whether it was a business or trading

¹ See supra pp. 10-11.

² 56 DTC 1125.

³ Ibid., p. 1137.

transaction.

.....
Nor is it essential to a transaction being an adventure in the nature of trade that an organization be set up to carry it into effect.

.....
A transaction may be an adventure in the nature of trade even although nothing was done to the subject matter of the transaction to make it saleable.

.....
The fact that a transaction is totally different in nature from any of the other activities of the taxpayer and that he has never entered upon a transaction of that kind before or since does not, of itself, take it out of the category of being an adventure in the nature of trade.

.....
A transaction may be an adventure in the nature of trade although the person entering upon it did so without any intention to sell its subject matter at a profit . . . for the intention to make a profit may be just as much the purpose of an investment transaction as of a trading one.⁴

On the positive side he notes:

If the transaction is of the same kind and carried on in the same way as a transaction of an ordinary trader or dealer in property of the same kind as the subject matter of the transaction it may fairly be called an adventure in the nature of trade. . . . Put more simply, it may be said that if a person deals with the commodity purchased by him in the same way as a dealer in it would ordinarily do such a dealing is a trading adventure.

.....
There is the further established rule that the nature and quantity of the subject matter of the transaction may be such as to exclude the possibility that its sale was the realization of an investment or otherwise of a capital nature or that it could have been disposed of otherwise than as a trade transaction.⁵

Let us now turn to an examination of each of these tests in turn to determine the way and the extent to which they have been applied.

⁴ Ibid.

⁵ Ibid., p. 1138.

Recurrence

In keeping with the "harvest tradition" of income which was discussed in the preceding chapter, one of the earliest tests applied in Britain was that of recurrence. As recently as 1931 an English court held that a profit resulting from the exercise of certain options was not taxable because there was no likelihood of recurrence.⁶ But this was evidently an anachronism as Goffman suggests⁷ that the taxability of an isolated transaction was established in Britain by the House of Lords in the leading case of Martin v. Lowry⁸ in 1927. In that case, Martin, who was an agricultural implements dealer, purchased a quantity of linen and resold it at a profit. Although it was the only time he had dealt in such a commodity, he was held to be taxable on the profit as the gain from a trade on the basis of other factors.

There would seem to have been no Canadian cases which were decided in a taxpayer's favor on the sole ground that the profit was likely not to recur. However, the ingenuity of the taxpayer in one case⁹ warrants mention. The appellant, assisted by her husband, a carpenter and former building contractor, constructed and sold one house a year over a five-year period. She personally supervised the work and hired workers. She claimed that she had been given to understand by the tax office that she

⁶Lowry v. Field, [1931] 2 All E.R. 735 (King's Bench).

⁷I. J. Goffman, "The Tax Treatment of Capital Gains in Canada," National Tax Journal, XIV (December, 1961), p. 356.

⁸[1927] A.C. 312.

⁹#215 v. M.N.R., 54 DTC 549.

could do this without incurring tax liability on the profit. The Income Tax Appeal Board held that she was taxable as being essentially in the business of speculative building, and suggested that had she not supposed that she could build and sell one house per year tax free, she would have built more. It seems that the recurrence concept lives on in the minds of some taxpayers, if not in those of revenue officials. However, it is quite apparent that recurrence as a test of income is of little importance in Canada today.

Setting Up an Organization

The second test, the setting up of an organization, has had little separate discussion in Canadian courts. From one point of view it is merely one factor in determining whether the transaction was carried out in the way a trader would do it. An outstanding example of a case which turned on there being an organization set up was that of Martin v. Lowry discussed above.¹⁰ The fact that an office was rented for some seven months and that a substantial selling organization was set up weighed heavily in the decision to tax the profits. While Mr. President Thorson gave expression to the converse of this in his second negative proposition, it must be remembered that he sought to set out tests of which some but not all must be satisfied in order to render a profit taxable.¹¹

¹⁰ Supra, note 8.

¹¹ For example in the case of Cohen v. M.N.R., 57 DTC 1183, in which the matter of organization is specifically mentioned, the court found that none of the tests was satisfied and thus the appellant was not taxable.

Something Done to Make the Asset Saleable

Again with the third negative proposition there seem to be no Canadian cases which are in direct support. Moreover, those which do deal with fact situations in which something has been done to the asset to make it saleable (i.e. the positive side of the proposition) seem to cast some doubt upon it. In at least three cases¹² where land acquired for one purpose was subdivided and sold in lots it was held that the owners were merely choosing the best means of realizing an investment and they were not taxed on the profits. In both the Gibson and McGuire cases the appellant purchased farm land, established a home thereon, and, on finding it unprofitable to continue agricultural operations, subdivided the unused land and sold a number of the lots. In the Gibson case Mr. R. S. W. Fordham said that Gibson merely "followed the most sensible course open to him in deciding to sell the unneeded land in lots."¹³ Counsel evidently did not cite the Gibson case when the McGuire case came before the Exchequer Court some five months later. While Hyndman, D. J. relied mostly on the appellant's intention in purchasing the land in the latter case, he also suggested that the appellant had merely chosen the best way of disposing of the land and that it seemed that it should make no difference for tax purposes whether the land was sold as a whole or in subdivided parcels.

¹² Gibson v. M.N.R., 55 DTC 618; McGuire v. M.N.R., 56 DTC 1042; Pardee v. M.N.R., 60 DTC 547.

¹³ p. 619.

The Pardee case presented a somewhat different situation. There, three officers of a new company, one of whom was also a shareholder, purchased land to be used by the company as a building site. When it became apparent that the company would be unable to finance a building, the land was subdivided and, after some considerable effort on the part of the appellants, sold. Mr. M. Boisvert of the Tax Appeal Board, in his reasons for judgment, claimed that the property had been bought as a capital asset with a specific purpose in mind. If the plan had materialized, the appellants stood to benefit materially from the increased business which would have resulted over the years. When the land was no longer suitable for the purpose for which it was purchased, they had every right to dispose of it in the best possible way. When all the circumstances of the case are considered, it seems difficult to reconcile it with the others, and it appears unlikely that it will find wide application.

The Regular Business of the Taxpayer

The profit arising from a transaction which so closely resembles the regular business of the taxpayer as to be virtually indistinguishable from it would appear particularly vulnerable to taxation as income from a business, and there is considerable judicial discussion of this point. One of the earliest judgments dealing with the matter was that of Kennedy v. M.N.R.¹⁴ The appellant, classed as a "speculative builder," purchased land from an estate and between two and three years later sold part of it

¹⁴ 52 DTC 1070.

at a profit to the Ontario Government for right of way for a highway. In addition to the appellant's admission that he had thought the property was "a good buy" there was the fact that part of his business was buying land for resale. Archibald, J. concluded that the purchase was so close to his regular business that it must be considered part of it and thus the profit was taxable.

In the case of #351 v. M.N.R.,¹⁵ the appellant was an officer of two grain companies, one of which dealt regularly in grain futures as part of its business. When he purchased grain futures on his own account he was found taxable on the profits. In giving judgment Mr. C. L. Snyder of the Income Tax Appeal Board said:

In view of the careful study made by the appellant of the grain market, the close association between the operations of the two companies of which the appellant was a shareholder and the appellant's transactions in grain futures, as well as the frequency of these ventures. . . , it must be found that the profits realized in these transactions resulted from a business carried on by the taxpayer.¹⁶

Chesler v. M.N.R.¹⁷ presented a similar situation. The appellant, who had been connected with the brokerage business in a number of capacities over a period of years, was persuaded by a broker friend to buy a number of shares of mining stock. After hearing discouraging news about the mining property a few days later, he sold the shares. Shortly thereafter he was again persuaded to buy the same shares with the same

¹⁵56 DTC 375.

¹⁶Ibid., p. 377.

¹⁷60 DTC 156.

result. In both cases he made a substantial profit on selling. While the Board pointed to the rapid turnover of shares as evidence that the deals were of a commercial or speculative nature, they also stressed the fact that the appellant was well versed in the business of buying and selling shares and this factor certainly contributed to the finding that the profit was taxable.

How far will the courts go in holding that the profit from a transaction resembling one's ordinary business is taxable? The interesting Dupuis case,¹⁸ of which we will consider another aspect later, provides a partial answer. Dupuis, an insurance agent, and a stockbroker friend entered into a somewhat complicated transaction in order to purchase the shares of a paint company which they felt would provide them with an excellent investment and future security. They first borrowed the necessary funds from a bank. Then they incorporated a holding company and exchanged the shares of the paint company for preferred and common stock of the holding company. The shares of the holding company were pledged with the bank as collateral for the loan. The understanding was that the preferred shares would be sold to repay the loan and that the appellant and his partner would retain the common shares and, thus, control of the holding company. Because of a downturn in the market for preferred shares it was found necessary to abandon the original plan and to sell a number of the common shares. Most of these were subsequently

¹⁸ Dupuis v. M.N.R., 60 DTC 81.

repurchased and were held by the two men at the time of the appeal. One of the main points relied upon by the Minister was that Dupuis' partner was a stockbroker. Mr. J. Panneton, who heard the case for the Tax Appeal Board, concluded that the transaction was certainly foreign to Dupuis' business and the fact that he had entered the deal with a stockbroker (who had been his long-time financial adviser) did not alter the situation. While this did not entirely decide the case, it at least indicates that the association with the broker was not sufficient to tip the scales against the taxpayer in the face of other considerations in his favor.

Three other decisions of the Tax Appeal Board, all of which were decided in a period of two months, throw further light on the question. In Fine v. M.N.R.,¹⁹ the appellant, a furniture dealer, had entered into a number of real estate transactions prior to 1952 and had paid tax on any profits gained therefrom. He continued to rent his remaining property until 1956 and 1957 when he disposed of three properties, one of which had been transferred to his wife. With the proceeds he purchased a building which was closer to his place of residence and thus more easily managed and supervised. When he became ill shortly thereafter, he sold this as well. Mr. Chairman Snyder, in holding that he was not taxable on the profits from these transactions stated:

The fact that the appellant, until 1952, bought and sold real estate does not settle that real estate owned by him should

¹⁹61 DTC 628.

always be considered stock-in-trade. It is the manner in which the real estate is dealt with that determines such a question for the purpose of interpreting the Income Tax Act.²⁰

The reasons advanced by the appellant for disposing of the property were held to be valid ones and were consistent with the sale of an investment.

The case of Green v. M.N.R.²¹ presented a similar fact situation. The appellant, an electrical contractor, had engaged in numerous real estate transactions over a period of years. He had sought to distinguish between those which were investments and those which were of a speculative nature, paying tax on the profits from the latter. The property in question in the appeal had been bought in 1952. When an unsolicited offer was received for the property in 1957 the appellant sold it, claiming as reason for selling the fact that it needed renovations and repairs and had rats. Mr. M. Boisvert was even more emphatic in allowing the appeal than Mr. Snyder had been.

. . . holding that the profit he realized on that specific transaction may not be claimed as a capital gain, because he had previously engaged in real estate transactions giving rise to taxable income, would be tantamount to ruling that any person who has derived a profit assessable to income tax upon the sale of some real estate property is barred, from then on, from claiming a capital gain on the sale of other properties from which he may have derived rental income for many years. No such conclusion would be supported by the Income Tax Act.²²

The third case is that of Anderson v. M.N.R.²³ The facts, which resemble those of the other two, were briefly that the appellant, a shoe

²⁰ Ibid., p. 631.

²¹ 61 DTC 698.

²² Ibid., p. 700.

agent, purchased farm and pasture land for his retirement. He rented the land for some time and made considerable improvements to it. The pasture was in a low, wet area and when it became too expensive to continue to maintain it, he disposed of it. When he became ill the following year, he sold the farm as well. In the meantime, he had entered into a number of other real estate transactions. Mr. Chairman Snyder admitted that Anderson was experienced in real estate matters, but ruled that the farm and some of the other property had been investments. He found the appellant taxable on the remainder of the property which he had bought and sold.

Thus far we have concerned ourselves with individuals. However, problems arise with sales by business enterprises (incorporated or not) as well. It was thought for some time that the profit earned by a company in carrying out one of its objects or powers would be taxable. However, the Sutton Lumber case²⁴ silenced this line of reasoning. Mr. Justice Locke, in giving the decision of the Supreme Court of Canada, pointed out that it was what the company in fact did, and not what it could do under its memorandum, that should be the deciding factor. Let us examine two cases to see what the courts now look for in deciding whether certain business receipts are taxable.

In the case of M.N.R. v. B. A. Motors Toronto Ltd.²⁵ the Minister

²³
61 DTC 712.

²⁴
53 DTC 1158.

²⁵
53 DTC 1113.

sought to assess the profits from the sale of two different types of assets, one of which need not concern us here. The respondent was a new and used car dealer in Toronto. The asset in question was an automobile that had been used by the company in its business for five years. During that time it had been treated for accounting purposes as a capital asset and depreciation had been charged on it. It had been sold at the end of that time to an auto wrecker. While he noted that automobile dealers do not normally make their money selling used automobiles to auto wreckers, Mr. Justice Cameron found the profit not subject to tax on another ground. He said:

I do not think that the profit on such sale is converted from a capital profit to an inventory profit merely because the taxpayer happens--as here-- to be a buyer and seller of the same commodity as the depreciable capital asset itself. . . . Where it has been clearly established that a motor vehicle has been bought for use as a capital asset in the necessary service of the taxpayer, has been used in the same manner and to the same extent as a capital asset would normally be used, and has always been treated and recognized as a capital asset, the profit which may arise upon its disposition is a capital profit.²⁶

The second case is a decision of the Supreme Court of Canada, Frankel Corp. v. M.N.R.²⁷ The appellant dealt in ferrous and non-ferrous scrap, was engaged in smelting and alloying of non-ferrous metals and also carried on business in wrecking, salvage, and steel fabrication and erection. At the end of 1951 the company sold the non-ferrous part of the business, including equipment, machinery, inventory (regardless

²⁶ Ibid., p. 1116.

²⁷ 58 DTC 1173.

of the stage of process), accounts receivable, goodwill, patents, trademarks, unfilled orders and so on. The property on which that part of the operation had been carried out was leased to the purchaser for a four-year period and all the appellant's employees in that part of the business were transferred to the purchaser. The Minister sought to tax the profit on the sale of the inventory.

The court noted the fact that the entire business had been disposed of and that the appellant was no longer in the non-ferrous metal business. The contract of sale covered the entire business and was indivisible. The court concluded that the sale of the inventory was not a sale in the business of the appellant but was made as part of a sale of the business of the appellant. Consequently the proceeds did not come within the meaning of income from a business in S. 4 of the Income Tax Act.

It should be noted, however, that under section 85 (E) of the Income Tax Act, enacted in 1955, such a profit would be subjected to tax. Since the sale in question here took place before that time, the provision did not apply.

It thus appears, by way of summary on this point, that while remoteness from the taxpayer's regular business does not ensure that a transaction will not be an adventure in the nature of trade, proximity to his regular business does not necessarily mean that it is such an adventure. It is still necessary to consider other factors to determine if their combination will make a profit taxable.

Intention

It seems fitting that among the negative tests for an adventure

in the nature of trade Thorson, P. should leave intention to the last. In reality, intention is at the very core of the distinction that is sought to be made. However, intention is not easy to determine. By its very nature it is subjective. It goes almost without saying that it is impossible to ascertain accurately or entirely a person's intention in a given act, even with modern psychological techniques. One's mental processes do not readily lend themselves to clinical observation. Moreover, it is not possible to accept a person's explanation of his intent as prima facie evidence of what that intent, in fact, was. What, then, can be done?

Mr. Justice Duff provided an answer in an early case where he said, "The law does not . . . take note of subjective events in the stream of consciousness save in relation to or as manifested by some external word or deed."²⁸ Thus the court attempts to infer the taxpayer's intention from all the surrounding circumstances of the case. Yet even this is not always a simple thing to do.

The well-known case of Californian Copper Syndicate v. Harris²⁹ provides an early example of the sort of things which the courts look for in attempting to determine intention. The appellant was incorporated as a mining company with very broad powers. It used most of its capital to purchase a mine which was subsequently sold at a profit. Although the appellant was paid in shares for the property, the court held

²⁸Bawlf Grain Co. v. Ross, (1917) 55 S.C.R. 232 at 255.

²⁹(1904) 5 T.C. 159 (Court of Exchequer Scotland Second Division).

that they had not merely exchanged one investment for another. The fact that they had insufficient funds with which to develop the mine was evidence to the court that the intention of the company was to exploit the property by early and profitable sale. On that basis they held that the profit was taxable.

In the McGuire case which was discussed earlier,³⁰ the fact that the property had been purchased originally as a home for the appellant and his family, and had been so used for a number of years, contributed to the court's finding that the profit resulting from its sale was not taxable. The appellant had not intended to resell the property but to live on it, the court concluded.

Another case in which the taxpayer was successful on the basis that there was no intention to make a profit from a transaction was that of Dennis v. M.N.R.³¹ The appellant was sixty percent owner of a number of apartment buildings valued at between twenty and twenty-five million dollars, with the rental therefrom providing his income. He purchased a farm with the avowed intention of farming as a hobby. The following year substantial gravel deposits were found on the farm. He sold the gravel (reporting the income) and then, after receiving an unsolicited offer, sold the farm a month later at a substantial profit. He later purchased another farm which he continued to operate on a large scale at the time of the appeal.

³⁰ Supra, note 12.

³¹ 61 DTC 65.

The Tax Appeal Board held that as the appellant already had a more than adequate source of income and substantial assets he was not looking for new sources of income. He was busy enough, Mr. Fordham suggested, without going into the buying and selling of farms on the side. Dennis had simply wanted a dairy farm, and when the property he originally purchased proved unsatisfactory for that purpose, he sold it when he received an offer for it.

Reasoning such as was used in these last cases may help the court to determine whether or not there was present an intention to make a profit from a given transaction. Yet is this alone sufficient to warrant taxation of the profit? It would seem not. In a British House of Lords case, Jones v. Leeming³² Lord Buckmaster stated:

An accretion to capital does not become income merely because the original capital was invested in the hope and expectation that it would rise in value; if it does so rise, its realization does not make it income.³³

Lord Warrington of Clyffe added in the same case:

The fact that the parties intended from the first to make a profit if they could does not in my opinion affect the question we have to determine.³⁴

In the Canadian case of #341 v. M.N.R.,³⁵ Mr. Fisher of the Income Tax Appeal Board concluded that intention alone was not sufficient to render a profit taxable. It is a factor--but only one factor--that must be considered.

³² [1930] A.C. 415.

³³ Ibid., p. 420.

³⁴ Ibid., p. 425.

³⁵ 56 DTC 231.

In Cosmos v. M.N.R.³⁶ Mr. Boisvert observed: "No one can deny that a person who makes any kind of investment intends to realize it some day."³⁷

In the recent case of Irrigation Industries v. M.N.R.³⁸ Mr. Justice Martland in delivering the majority judgment of the Supreme Court of Canada questioned whether the intention to sell at a profit as soon as possible was enough to bring a transaction within the category of an adventure in the nature of trade. He pointed out that in any case where securities are purchased there is some idea of selling at a profit. He concluded that there must be a clearer intention than that to constitute a trade.

Secondary Intention

Having seen that an intention manifest from the beginning of a transaction may or may not give rise to a taxable profit, the next question is whether a change of intention may have an effect on taxability. A first possibility is one where there was always an intention to make a profit and merely the means of making it changes; and a second is one in which there was initially no evident intention to make a profit but this intention later appeared.

At the outset of our discussion of intention it was suggested

³⁶ 61 DTC 721.

³⁷ Ibid., p. 723.

³⁸ 62 DTC 1131.

that intention was a difficult thing to find with any degree of certainty. Assuming this to be so, it seems extremely unrealistic to speak of determining a change in intention. However, the courts have recently embarked on such an approach and the result has come to be known as the doctrine of secondary intention.

Before examining this interesting doctrine (which is an attempt to deal with the second situation above) let us look briefly at the first situation.

Perhaps the best example is the case of Day v. M.N.R.³⁹ The appellant, on the advice of a real estate dealer, bought a block of land with the idea of subdividing it for resale. He had been working in a family business but had hoped to establish himself in the real estate field. After having drawn up a plan of subdivision, he encountered difficulties with the municipal authorities and eventually abandoned his plan. He continued to rent the land to the former tenant who was farming the land. In the meantime Day went into another line of business. He received an unsolicited offer for the entire block of land and decided to accept it. Mr. Justice Cameron admitted that while Day may have abandoned his original intention to subdivide the property and thereby sell at a profit he had never abandoned the intention of selling at a profit, per se. The fact that the land had been rented did not make the property an investment as the rental appeared to be only a stop-gap measure.

³⁹
58 DTC 1042.

The first Canadian case in which the so-called secondary intention doctrine appears is that of Bayridge Estates Limited v. M.N.R.⁴⁰ The appellant was an incorporated company with powers sufficiently wide to include the buying and selling of real estate. During its first year of operation the company purchased and resold one piece of unimproved property and paid tax on the profit. The following year the property in question in the appeal was purchased. It was located at a busy intersection in Montreal and the directors of the company planned to build a service station and motel on the land, with possibly a restaurant and cocktail lounge to be added later by the company or someone else. As the company had expended a large part of its funds on purchase of the land, construction of the service station and motel depended on arrangements being made with a major oil company to provide a loan of the necessary funds. Some negotiations had been carried out towards this end at the time the land was purchased and testimony indicated that the directors felt confident that such negotiations would be completed successfully. When the oil company later refused to approve the arrangement, and when no other source of funds could be located, the directors decided that their only alternative was to sell the property. This was done at a profit and it was that profit which formed the basis of the appeal. Mr. Justice Thurlow, in dismissing the company's appeal, stated: "The evidence, in my opinion, points to the conclusion that the property was acquired with the overall intention

⁴⁰
59 DTC 1098.

of turning it to account for profit."⁴¹

He pointed out that the company had hoped to borrow the funds necessary to carry out its original purpose, the building of a service station and motel. However, they intended to make a profit in any way possible and this seemed to include sale. He concluded:

In my opinion, the sale of the property for profit was one of the several alternative purposes for which the property was acquired, and it was in the carrying out of that alternative purpose, when it became clear that the preferred purpose was unattainable, that the profit in question was made.⁴²

A similar, though seemingly more clear-cut, case came before Thurlow, J. a few months later with the same result. In that case,⁴³ the appellant, a chemical engineer, in partnership with a doctor, was in the business of buying land, building houses on it, and reselling. In some cases in which mortgages to enable them to build could not be obtained, the unimproved land was resold. On each of these transactions profit or loss was duly reported and tax paid accordingly. The profit in question was different from the others, according to the appellant's claim. Two different parcels of land had been purchased with the idea of constructing apartment blocks thereon for rental purposes. The plans submitted did not fully comply with building regulations and when no mortgage money was available the land was sold. The distinction which the appellant sought to make was that the property had been purchased to be built on and retained as an investment, not to be sold as was the case

⁴¹Ibid., p. 1101.

⁴²Ibid., p. 1102.

⁴³Fogel v. M.N.R., 59 DTC 1182.

with other property the partnership had purchased. However, the court refused to admit the distinction, calling the difference one of "conditional intention." They concluded that the resale of unimproved property was one of the ways in which the partnership had made money from its inception. Thus the resale of the land gave rise to income.

As Mr. Justice Thurlow expressed it:

Since the scheme for apartments on the lots in question was both contingent and limited, I see no reason to think that the sale of these lots, as well, was not also contemplated as one of the alternative ways in which they would be turned to account for profit if the scheme for building apartments thereon should fail.⁴⁴

The real test of the doctrine came when the case of Regal Heights v. M.N.R.⁴⁵ reached the Supreme Court of Canada the following year. There, by a majority of four to one, the highest court in the country upheld the decisions of the Income Tax Appeal Board and the Exchequer Court and tacitly, if not explicitly, gave approval to the doctrine.

The facts were similar to those in the previous two cases. The appellant company purchased a parcel of land from its incorporators with the idea of erecting a shopping centre thereon. Negotiations were carried on with a major department store to locate in the centre but these fell through and the store decided to build elsewhere in the same vicinity. The land was then sold and the company wound up.

In delivering the majority judgment, Mr. Justice Judson stated:

⁴⁴ Ibid., p. 1185.

⁴⁵ 60 DTC 1270.

There is no doubt that the primary aim of the partners in the acquisition of these properties, and the learned trial judge so found, was the establishment of a shopping centre but he also found that their intention was to sell at a profit if they were unable to carry out their primary aim.⁴⁶

The court had to decide whether the secondary intention had been present from the beginning, as the Minister contended. They found that it had been part of the initial plan. In Mr. Justice Judson's words:

There is, understandably, no evidence of any intention on the part of these promoters to build regardless of the outcome of the negotiations. There is no evidence that these promoters had any assurance when they entered upon this venture that they could interest any such department store.⁴⁷

Thus it followed that since there was no guarantee of success there must have been present in the minds of the promoters a likelihood of failure in the carrying out of the avowed object of the undertaking. He concluded:

These promoters were hopeful of putting the land to one use but that hope was not realized. They then sold at a substantial profit and that profit, in my opinion is income and subject to taxation.⁴⁸

The words emphasized in the above passage provide the key to the decision. All the appellant had, in fact, was a hope that the lease could be arranged with the department store and that the shopping centre could be completed. There was no assurance of any arrangement being worked out and thus the strong possibility of the alternative led to the profit therefrom being taxed when it materialized.

⁴⁶Ibid., p. 1272.

⁴⁷Ibid.

⁴⁸Ibid., emphasis supplied.

Mr. Justice Cartwright, in dissenting, admitted that there may have been a secondary intention present, but felt that this was not enough to make the profit taxable. He said:

(The trial judge) has however held the profit realized subject to tax on the ground that reasonable and experienced business men, such as the promoters were, must have envisioned the possibility of being unable to carry out the scheme of developing the shopping centre and have hoped in that event to dispose of the land at a profit. Accepting this as a reasonable inference, it does not appear to me to justify the finding that the appellant was in fact engaged in the business of buying and selling lands. I do not think that the evidence supports the view that the appellant or its promoters would have purchased, or did purchase, the lands in question as a speculation looking to resale.⁴⁹

While it is unlikely that any court would find that the appellant was in the real estate business as it is popularly conceived of, the point that seems to have been missed in the above is that what is being referred to is business in the sense meant by the Income Tax Act. While "one swallow may not make a spring," one transaction may make an adventure in the nature of trade, which in turn comes within "business" as defined by the Act.

It would seem from the discussion so far that it is necessary for the secondary intention to have been present from the beginning in order for the profit to be taxable. However, this does not appear to be a necessary situation. In Casey v. M.N.R.⁵⁰ the Tax Appeal Board held what amounted to a changed intention taxable. While there were two

⁴⁹ Ibid., p. 1271.

⁵⁰ 60 DTC 466.

separate transactions involved, it is only with the second that we need concern ourselves. The appellant, who was in the automobile sales and service business, submitted a tender for the property of a bankrupt body shop for use in his own business, and it was accepted. Shortly after the deadline for tenders another tender was made for a higher price. This higher offer was submitted by a friend of the previous owner with the idea of putting the latter back in business. Since the appellant's bid had already been accepted, the second person approached the appellant and persuaded him to sell the business at the higher price indicated in the second tender, on the understanding that the original owner would, in fact, resume operation of the business. Mr. Fordham admitted that there was no intention to resell at the outset but he claimed that the appellant had changed his mind and on this basis he was taxable. While this case seems difficult to reconcile with previous ones on the basis of intention, the short time the property was held appears to have contributed to the decision.

The doctrine of secondary intention appears to have opened entirely new possibilities to the courts to find profits taxable which would not previously have been so. However, the test has been applied with considerable care, and there have been several instances where the courts ruled that there was no secondary intent.⁵¹

⁵¹ For example, in both Pardee (supra, note 12) and Dennis (supra, note 28) the court found that secondary intention as an alternative ground for taxation had not been proven.

We now turn our attention to Mr. President Thorson's positive criteria for determining an adventure in the nature of trade.

The Way a Dealer Would Do It

The problem of whether a transaction has been undertaken in the way that a dealer or trader would do it has often been raised in Canadian courts. This test, too, overlaps in its application with some of the others, and again is not sufficient by itself to result in taxation of any given profit.

As an example of the sort of thing the courts look for in determining whether this test has been satisfied, let us look at #371 v.

M.N.R.⁵² The appellant was a member of an investment group which had options on certain mining shares. She gave a broker limited authority to act as her agent in buying and selling shares. Some of the mining shares were sold before the options had been exercised, resulting in a profit. The Board ruled that the entire course of conduct was that of a person entering an adventure in the nature of trade. Special attention was drawn to the fact the shares had been sold short. This procedure was not one normally used when disposing of an investment but rather one which might be used by a dealer.

The case of Sterling Paper v. M.N.R.⁵³ provides an even more explicit idea of what the courts look for in this regard. The appellant

⁵² 56 DTC 553.

⁵³ 60 DTC 1171.

purchased the entire assets of another company, including certain timber limits, in order to obtain a paper mill. The timber limits were an unwanted part of the deal and the appellant made an unsuccessful attempt to dispose of them even before the deal was completed. The company subsequently ceased operations and disposed of its assets. The cutting rights on the limits were sold for a lump sum and the remainder was sold to the Quebec government. Mr. Justice Fournier, in finding that the profit on the sale of the cutting rights was not taxable remarked:

A trader in timber cutting rights on timber limits does not buy timber limits in a block or bulk sale with a number of assets with the intention of never using or selling the timber. He generally buys something with which he intends to deal commercially. He buys it with the intention of trading in it and thereby realize a profit. He does not buy a timber limit which he does not need because he is intent on getting something else in the deal, and then has to dispose of it because he never wanted it.⁵⁴

The facts and decisions in a number of cases might lead one to believe that the use of borrowed funds when undertaking a transaction is a conclusive hallmark of a trading venture. However, an excellent discussion in a case looked at earlier, Dupuis v. M.N.R.⁵⁵ would seem to have silenced this line of attack. Mr. Panneton examined a number of cases,⁵⁶ and in each found an alternative ground on which the case could be decided apart from the use of borrowed funds. He concluded that the use of bor-

⁵⁴ Ibid., p. 1177.

⁵⁵ Supra, note 18.

⁵⁶ Davidson v. M.N.R., 58 DTC 111; #492 v. M.N.R., 58 DTC 124; #527 v. M.N.R., 58 DTC 387; #526 v. M.N.R., 58 DTC 497; Dectar v. M.N.R., 20 Tax A.B. Cases 463; and 157-159 St. Paul St. Ltd., v. M.N.R., 58 DTC 661.

rowed funds was not an indication of a commercial venture by itself, or even in combination with the other factors present in that case.

In Irrigation Industries v. M.N.R.⁵⁷ Mr. Justice Martland, in delivering the majority judgment of the Supreme Court of Canada said:

I would not think that the question of whether securities are purchased with the purchaser's own funds, or with money borrowed by him, is a significant factor in determining whether their purchase and subsequent sale is or is not an investment.⁵⁸

Thus the use of borrowed funds, while it may be a factor in any decision, seems of little real importance standing by itself in stamping a transaction as a trading one.

The Nature and Quantity of the Subject Matter

An example of the nature and quantity of the subject matter being such as to preclude the possibility of investment can be seen in the Taylor case itself.⁵⁹ Taylor was an executive in a metal manufacturing company whose business included the fabricating of lead products. The company purchased its supplies of lead from a Canadian supplier but had found difficulty in obtaining their full requirements from that source. When lead prices took a sudden drop, Taylor suggested to the American parent company that imported lead be used as it was then sufficiently cheap to be competitive with Canadian lead, despite Canadian tariffs. As this would have involved buying lead futures, the parent company

⁵⁷ Supra, note 35.

⁵⁸ Ibid., p. 1132.

⁵⁹ Supra, note 2.

refused and Taylor decided to buy lead on his own account. He made a contract with the company to sell the lead to them at the Canadian price prevailing on the date of delivery. Without using any of his own capital he obtained 1500 tons of European lead and sold to the company at a handsome personal profit. It was this profit which the Minister sought to tax.

After the Income Tax Appeal Board ruled in favor of the taxpayer, the Minister appealed and Thorson, P. allowed the appeal. He pointed out that besides the fact that the lead was dealt with in the same way as a dealer would have done, the amount (1500 tons) and the nature (raw lead) of the subject matter were such as to clearly and unmistakably brand the transaction as a trading one.

One cannot help but wonder whether the case would even have come before the Board had it arisen after there had been some amount of litigation on the meaning of the then-new term, "an adventure in the nature of trade." It is difficult to believe that anyone would attempt to "invest" in 1500 tons of raw lead. Had the case not been the first of its kind, it probably would have attracted little subsequent attention.

As an example of the quantity of the subject matter being the deciding factor, we need only turn to the Californian Copper Syndicate case discussed earlier.⁶⁰ A similar situation arose in the case of M.N.R. v. Constant.⁶¹ The respondent and his partner were in the construction business. They incorporated their business and the company undertook to

⁶⁰ Supra, note 29.

⁶¹ [1958] C.T.C. 175.

build an apartment on some land which they continued to own as partners. They borrowed to finance the project but were forced to sell the building when creditors demanded payment. Mr. Justice Fournier of the Exchequer Court pointed out that their financial position would not have allowed them to keep the building as an investment. This, plus the similarity to their own and the company's business resulted in the profit being taxed.

One of the most clear-cut purchase and sale situations was thought for some time to be the purchase and resale of a non-income-producing asset. In the Dectar case⁶² for example, the appellant and another purchased unimproved land and resold it a few months later at a profit. The fact that it had no income-earning value weighed heavily in the decision to tax the profit.

In the case of McConnell v. M.N.R.,⁶³ the appellant purchased certain shares on the advice of her husband whose firm had advanced money to the underwriters. As the company was a new venture there seemed no prospect of dividends for some time. She sold the shares three months later at a substantial profit. The Board pointed to the unlikely prospect of dividends and ruled that her profit was taxable.

However, two recent cases seem to suggest that even this point is not necessarily a decisive one. In Cosmos v. M.N.R.,⁶⁴ Mr. Boisvert states:

⁶² Supra, note 54.

⁶³ 60 DTC 173.

⁶⁴ Supra, note 34.

An asset acquired by a taxpayer for investment purposes need not bear fruit . . . in order that the profit realized when it is resold should be deemed to be in the nature of a capital gain.⁶⁵

In Irrigation Industries v. M.N.R.⁶⁶ Martland, J. puts it even more forcefully when he says:

. . . the fact that there was no immediate likelihood of dividends being paid on the shares should not have much significance, for there are many corporate ventures, financed by the sale of shares to the public, in which immediate payment of dividends may not be anticipated. . . .⁶⁷

In this latter case a virtually dormant feedmill company borrowed money and purchased treasury shares of a mining concern. Shortly thereafter the company resold the shares (alleging a number of reasons for their action) and realized a considerable profit in the process. The Supreme Court by a three to two decision reversed the Appeal Board and Exchequer Court and found the profit not taxable. The court commented:

. . . the purchase of the treasury shares of a company embarking on a new enterprise is a well-recognized method of making an investment.⁶⁸

One class of gain that has attracted a considerable amount of attention in recent years is the mortgage discount. We will examine two cases which seem to represent the extremes in dealing with such gains.

One of the first and most widely-quoted cases in this area is that of Cohen v. M.N.R.⁶⁹ Cohen, a 76 year old semi-retired businessman dis-

⁶⁵ Ibid., p. 721.

⁶⁶ Supra, note 36.

⁶⁷ Ibid., p. 1132.

⁶⁸ Ibid.

⁶⁹ Supra, note 11.

posed of all of his securities and with the proceeds plus some additional funds he purchased a number of short-term mortgages at a discount. The mortgages paid the going rate of return and the ones purchased had been recommended to him by his solicitor. They were all held to maturity and the discounts thus realized were assessed for tax purposes by the Minister. The Exchequer Court found him not taxable on the amounts so received. There was, the Court claimed, no involved scheme of profit making. The appellant merely accepted or rejected offers from his solicitor. The interest rate on the mortgages was the normal one and the discounts represented a real risk. The appellant was not motivated solely by the prospect of the discounts, the Court decided, and the fact that all were short term (thus enhancing the possibility that the discounts would be realized) was necessitated by the age of the appellant.

At the other extreme we have the case of M.N.R. v. Spencer.⁷⁰ The facts were somewhat similar to those in the Cohen case, but sufficiently different that the amount realized in the form of discounts was found taxable. The respondent, a lawyer, and his partner purchased numerous short-term second mortgages at a discount and occasionally made mortgage loans. Most of the mortgages were held to maturity although some had been sold in order to realize needed cash.

Thorson, P. considered a number of factors in arriving at the decision to hold the discounts taxable. Not only were these second mort-

⁷⁰
61 DTC 1079.

gages but they were poor ones, their interest rate being below the going rate on second mortgages. They were acquired through business contacts and special organization was not necessary. The number of transactions and the rapidity of turnover provided further indication that the respondents were dealers in such assets. The fact that the mortgages were held to maturity, while it complicated the situation, was not sufficient to make them investments. In any event, the fact that the mortgages in this case were second class ones seemed to contribute to the difference between the two decisions.

An Undertaking of Any Kind Whatsoever

From the outset of the discussion above we have examined the meaning of the term "an adventure in the nature of trade" as if it were the only special class of transaction included in the definition of "business" in the Act. This view must now be somewhat modified. In Drumheller v. M.N.R.⁷¹ the court gave an interpretation of "income from business" which, if given widespread application, could mean the end of any possibility of making a capital gain in Canada. In that case Mr. Justice Thurlow applied the alternative clause of section 139(1) which brings an "undertaking of any kind whatsoever" within the scope of income from business. On the basis of those words a taxpayer could be assessed on virtually any profit even if not earned as part of a regular business or in the process of

⁷¹
59 DTC 1177.

engaging in an adventure in the nature of trade.

In the words of Thurlow, J.:

Business is defined by the statute in wide terms. It is not limited to trading or manufacturing but includes, as well, the carrying on of a profession or vocation. It also includes an undertaking of any kind and an adventure or concern in the nature of trade but not an office or employment. The expressions used in this definition are not mutually exclusive, nor are they equally broad. Some overlap others. In particular, the expression 'or undertaking of any kind' appears to me to be wide enough by itself to embrace any undertaking of the kinds already mentioned in the definition; that is to say, trades, manufactures, professions, or callings, and any other conceivable kinds of enterprise as well.⁷²

In reference to the case before him, he continued:

Whether or not this project can properly be classed either as a trade or as an adventure or concern in the nature of trade is, to my mind, quite immaterial for, in my opinion, it clearly falls within the meaning of the expression 'an undertaking of any kind' and must accordingly be regarded as a business for the purposes of the Income Tax Act.⁷³

While this is the only case in which the court has resorted to using the words on which the judgment turned, it means that there now exists precedent for their use in future. Whether the phrase will be invoked more frequently in future years remains to be seen. Meanwhile the general rule would seem to be that any transaction not qualifying as an adventure in the nature or trade will remain non-taxable. What this latter expression means, while still far from clear, is the result of the vast amount of judicial discussion summarized above.

⁷² Ibid., p. 1180.

⁷³ Ibid.

CHAPTER IV

ECONOMIC CONSIDERATIONS INVOLVED

IN CAPITAL GAINS TAXATION

Introduction

We now turn our attention to an examination of the economic effects of the imposition and continuance of a tax on capital gains. We must be careful to maintain the distinction between these two aspects of the problem, as much of the analysis depends on which we are considering. Unless otherwise specified, we will assume throughout the chapter that when a capital gains tax is imposed there will be no coincident changes in other tax rates. If the tax replaced some existing revenue source, the economic effect would be quite different.

It shall also prove helpful to assume that the average taxpayer has a clear idea in his mind as to the tax meaning of a capital gain, as this is essential to a discussion of the effects of capital gains taxation on various aspects of the economy. It will be difficult enough to ascertain the effects of such a tax without the picture being complicated by unnecessary uncertainty on the part of the taxpayer regarding the tax consequences of a given transaction.

Before analyzing the effects of the tax, the economic nature of capital gains must be ascertained. We must determine what a capital gain is, whether it can properly be classed as income or some species thereof,

whether it is a proper subject for taxation and if so, what the nature of such taxation should be.

The Nature of Capital Gains

We have already had a brief encounter with two definitions of capital gains¹ and we must now examine these and a number of others in somewhat more detail.

A capital gain may be defined in one of two ways--either in terms of the type of asset concerned, or in terms of the way in which the gain arises. As examples of the former we have the definition by Seltzer mentioned above,² and Anderson's comment:

Before we can define capital gains and losses, we must be able to define the source from which the gain is derived. In other words, we must first know what a capital asset is. In the broad economic sense, a capital asset is any asset or property held for the further production of wealth or as a source of income.³

The distinction often drawn between regular stock-in-trade and other types of assets is a further refinement of this type of definition.

Looking at the situation from the second viewpoint, the unexpected nature of the gain becomes important. However, with today's well-developed asset markets and rapid and comprehensive reporting systems, one cannot help but wonder just how unexpected most gains are. It seems difficult to

¹Supra, pp. 3-4.

²Supra, Chapter I, note 4.

³William H. Anderson, Taxation and the American Economy: An Economic, Legal and Administrative Analysis (New York: Prentice-Hall, Inc., 1951), p. 210.

conceive of any but the most naive purchaser of securities⁴ who would not consider the possibility of some appreciation or depreciation of his holding over a period of time.

In addition, a capital gain is thought of as unsought after.⁵ This is subject to doubt for the same reasons as was the unexpected nature of such gains. While capital gain may not be the prime motive in many transactions, it is undoubtedly one motive in a large number of cases.⁶

To combine the two by way of summary, a capital gain should be both unexpected and unsought after (if either can be said to be possible), and should involve capital assets (those intended to be held to produce further income or its equivalent as distinct from those intended to be exploited by direct resale). Perhaps the best way of expressing it is that of Taylor who says that we are concerned with the gain "of the irregular or unusual sort, occurring outside the normal course of earning one's income."⁷

Capital gains may arise in several ways. Seltzer suggests that

⁴L. H. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (New York: National Bureau of Economic Research, 1951) claims that the majority of gains in the United States are made on securities (p. 145).

⁵See for example Pigou's definition of windfalls, supra, p. 3.

⁶This brings us back to the whole matter of intention discussed in the preceding chapter. If an organized seeking after gain were found in a Canadian situation, any profit resulting would probably be taxed.

⁷Philip E. Taylor, The Economics of Public Finance (3rd ed.; New York: The Macmillan Company, 1961), p. 395.

there are three types of change giving rise to windfall additions to assets,⁸

The first of these is a change in the expected future stream of income flow. The rational investor will make an estimate of this expected income, no doubt weighted on the basis of the probability of receipt of each of several amounts. Then, by discounting the income at whatever rate of return he feels he needs or wants, he arrives at a present value for the asset. A number of considerations will enter into the making of the estimate, including the probability of large gain, the probability of loss and so on. In the case of readily producible assets, the production cost will set an upper limit.

The second change is one of interest rates. Since interest yields vary inversely with the value of the asset, interest rate changes affect values of interest-bearing assets. They may also influence the rate at which future returns from any asset are discounted to arrive at a present value.

The third change is in the investor's disposition to face uncertainties. To the extent that the expected future return from an asset is subject to risk, the investor will normally want extra compensation to induce him to undertake the risk. However, attitudes towards uncertainty change. Changes in the compensation required to induce an investor to assume risk affect asset prices through an effect on the rate of discount.

⁸ Seltzer, op. cit., p. 54.

Are Capital Gains Income?

Having arrived at a rough idea of what a capital gain is, we must now decide whether it is income or some form thereof. On this point economists are far from agreement. The answer depends on the definition of income chosen. Due puts forward two alternative definitions, consumption-plus-increase-in-net-wealth and flow-of-wealth⁹ and suggests that capital gains, so long as they do not merely represent general price level increases, fall within either.¹⁰ His statement elsewhere¹¹ that the second definition takes account only of realization, and not accrual, merely reflects his acceptance of the view that only realized gains can be taxed. He deals very little with the reasons for or against that view. Goffman feels that there is no fundamental fiscal difference between capital gains and so-called "ordinary" income.¹²

Anderson has some reservations about the inclusion of capital gains as income.¹³ He feels that such gains probably do not represent an addition to the flow of goods and services for the individual taxpayer, and that they do not increase his satisfaction. However, when they are realized, they can command goods and services.

⁹ John F. Due, Government Finance: An Economic Analysis (rev. ed.; Homewood, Ill.: Richard D. Irwin, Inc., 1959), pp. 125-7.

¹⁰ Ibid., p. 185.

¹¹ Ibid., p. 127.

¹² I. J. Goffman, "The Taxation of Capital Gains: An Economic Analysis," The Canadian Journal of Economics and Political Science, XXVIII (May, 1962), p. 235.

¹³ Anderson, op. cit., p. 211.

Smith is emphatic in his assertion that capital gains are not income.¹⁴ He refuses to accept the consumption-plus-net-increase-in-wealth definition of income. Elsewhere he states, "Income may well be defined as what an individual can spend without believing that he has reduced his capital."¹⁵ A person cannot, he claims, spend a capital gain without feeling that his capital has been reduced.

But there are a number of differences between capital gains and ordinary income. Since capital gains do not occur regularly, the prudent man will not count on their receipt as part of his normal standard of living. Further, to the extent that only realized gains are taxed, it is possible to choose the timing of realization so as to minimize tax in a way that is impossible with most income. Gains tend to follow the business cycle and the price level in a way that ordinary income does not. Because of this some writers argue that capital gains are not real. If it were true that all prices rose and fell to the same extent, this argument might be more acceptable; however, this is not the case. Groves concludes that "there are so many gains and losses associated with inflation, some real, some unreal, that it would probably be impossible to

¹⁴ Dan Throop Smith, "Tax Treatment of Capital Gains" in U. S., Congress, House, Committee on Ways and Means, Tax Revision Compendium (3 vols.; Washington: U. S. Government Printing Office, 1959), II, 1233.

¹⁵ Dan Throop Smith, Federal Tax Reform: The Issues and a Program (New York: McGraw-Hill Book Company, Inc., 1961), p. 121.

counteract their injustice by compensatory tax provisions and unwise to try."¹⁶

Moreover, it is possible for persons to change what would normally be income into a form of capital gain. The most obvious example of this is the case of corporate earnings. While these are usually subject to corporation taxes, the individual shareholder does not pay tax on his share of the earnings directly until he receives dividends. But by retaining profits in the company, the value of the shares is normally increased. Thus income is converted into capital gain. However, except in the case of family or other closely-held corporations, shareholders have little control over dividend policy, so that deliberate manipulation of this type is probably not widespread. The choice between paying dividends and retaining profits in any company is motivated by many factors, and tax considerations may not be important in many cases.

By making a study of the market and looking for potential capital gain situations, a person may realize appreciation on assets which is at least partly a personal wage. If the person were to conduct the same market analysis on behalf of someone else, he would be entitled to remuneration. Another means of converting wage income to capital gains is through paying executives in the form of stock options, thus enabling them to purchase company shares at prices below those ruling in the market. It must

¹⁶ Harold M. Groves, "The Taxation of Capital Gains," in U. S., Congress, House, Committee on Ways and Means, Tax Revision Compendium (3 vols.; Washington: U. S. Government Printing Office, 1959), II, 1198.

be remembered that these methods assume practical importance only if there is a difference in tax treatment between the two categories.

Problems in Taxing Gains

Should capital gains be taxed? If there is, as some suggest, no difference between capital gains and ordinary income, then there would appear to be no reason why the two should not be taxed in the same way and at the same rates.

However, it seems that such a view has found little support on a practical level, and almost every country differentiates between the two for tax purposes. In some countries gains are excluded entirely from the tax base, in some they are partially excluded, and in others they are included but taxed at a lower rate.

Even among persons who feel that capital gains are not really income there are those who feel that they give rise to taxable capacity. It is argued that since gains can be spent or saved in the same way as other income, they should be no less subject to taxation. This is met with the contention that since such gains do not recur regularly they do not give rise to as much taxpaying capacity as more regular receipts. The question is whether a clerk who normally receives \$5000 per year and suddenly in a given year receives in addition a gain of \$10,000 has the same taxable capacity in that year as the vice president of the firm for which he works who receives \$15,000 salary every year.

The previously-noted argument that a prudent man would not take account of possible capital gains in planning his consumption has been

used to support virtual confiscation of such gains. Since he did not expect the gain and did not require it to ensure his planned standard of living, a person will be in no worse position if it is taken from him when it arises than if it had never arisen in the first place.

If capital gains are to be taxed, several alternative methods present themselves. They may be taxed in a similar manner to ordinary income, including them fully and taxing them at the same rates. Or, as in the case of the United States, they may be taxed at a lower rate than that applicable to other income.

But perhaps the most important (and difficult) choice that must be made is one between taxing gains as they accrue or only when realized. Since income tax is an annual levy the subject of taxation should be the income (however defined) for the year. If capital gains are considered as income for tax purposes, those arising during the year should be taxed.

On the other hand there are compelling arguments of a practical nature which suggest that tax should be levied only on realized gains. While many assets are widely traded and their values are readily ascertainable, numerous assets are not so easily valued. Particularly in the case of the latter assets, and with some of the former as well, an accurate value cannot be determined except through an actual transaction. Any other valuation is likely to be highly subjective and arbitrary. Numerous inequities would almost certainly result and with existing progressive rate structures, errors might never be fully compensated.

Problems of payment may also arise. While the enjoyment of an unrealized gain may leave a person better off in some economic sense, it

does not provide him with the necessary funds to meet any tax liability which may arise. Moreover, since the gain was not provided for in the individual's budget, it is unlikely that he would have provided other funds for payment for tax thereon. Persons could be forced to make partial or complete liquidations of their holdings in order to meet tax liability. If enough people were to do this there would be disastrous results for asset markets. Indeed, the very gain on which the tax was to be paid could disappear in the attempt to raise the funds with which to pay the tax.

Yet a person may gain much economic benefit even from an unrealized gain. To the extent that the gain reflects an increase in potential earning power, the holder of the asset in question can expect to be better off in the future. Admittedly the tax on the increased future earnings will be higher than it would have been; but, apart from a tax which confiscates the increased income, there will be a net gain. As between two persons with identical asset holdings, it does not appear equitable to tax the gain of one who (for whatever reason) may be forced to sell, and leave untaxed the gain of the other who is able to retain his asset. The former suffers a loss of future income relative to the latter.

A further though perhaps less significant benefit to be derived from an unrealized gain is that it increases the value of the asset as collateral for borrowing. For a person who finances his business ventures with borrowed funds, this will have particular importance.

An additional reason for taxing gains as they accrue results

from the progressive nature of income tax rate structures in most modern Western nations. The realization of a gain in a given year would quite possibly force the taxpayer into a higher tax bracket. To tax a gain that has accrued over a number of years at such high rates places an undue burden on the taxpayer. Thus numerous writers have suggested some form of mitigation for this situation.

One of the simplest methods, though one which is far from being a solution to the problem, is that which is inherent in the United States practice of taxing all long-term gains at a maximum rate of twenty-five percent. This ensures that the high bracket rates (ninety-one percent maximum in the United States) do not apply to long-accruing gains. There has been much criticism, which seems quite justified, of the American distinction between short- and long-term gains. The boundary has been drawn at six months, with all gains arising within that time being taxed as regular income rather than being accorded the special treatment outlined above. The choice of a six-month, rather than a one-year, period is puzzling. Surely, if gains are to be taxed as income, and the income tax is to be an annual levy, there is no doubt that gains arising within a year should be subject to tax as income for the year. There is no justification as with gains arising over a period longer than a year to give preferred treatment.

A second means of alleviating the tax consequences of the "bunching" of gains resembles the first in some respects. Either the rate of tax or (what is virtually the same thing) the percentage of the gain included in taxable income varies inversely with the length of time the

asset has been held. Gains from assets purchased and sold within a year would presumably be taxed in full while assets held more than a certain number of years might be entirely exempt. A procedure similar to this is currently in use in Sweden.

A final proposal involves the averaging of the gain over a period of years, either the length of time the asset has been held or some arbitrary period such as five or ten years. While this would involve the reopening of taxpayers' accounts and a consequent recalculation of tax for a number of years, the administrative problems should not prove insuperable. Such a practice has been carried on with seeming success in the case of farmers under the Canadian Act. Although this scheme undoubtedly distorts the actual pattern of annual income throughout the period it is perhaps the best compromise possible between theoretical and practical considerations.

We must not presume that all asset values will necessarily rise. There will undoubtedly be those which will fall, and the treatment of these capital losses for tax purposes gives rise to further problems. One thing is certain: whatever capital gains are, capital losses are the opposite. If capital gains are income, losses are deductions; if capital gains give rise to taxable capacity, losses represent decreases in such capacity; if capital gains should be taxed, capital losses should give rise to tax deductions.

But if we choose to tax capital gains we are still not certain as to the nature of relief to be given for capital losses. An accrual basis for recognizing losses is indicated; once again practical consid-

erations negate this method. But even taking losses into consideration on a realized basis does not solve the problem. Are losses to be deducted from capital gains? Presumably. If realized losses exceed realized gains, should the excess be deducted from other income? Ideally, this would be so. However, American experience during the catastrophic loss years of the early 1930's was that many wealthy persons realized sufficient losses to offset their entire earnings and thus were able to live tax-free while continuing to enjoy a high standard of living. Moreover, many of the transactions in which the losses were realized were little more than paper ones--the securities were sold to relatives or friends in order to establish the loss and subsequently repurchased at the same price. Losses seem particularly vulnerable to manipulation regarding the time of most opportune realization. The present American practice of allowing deduction of losses against gains plus \$1000 of other income annually, with a five-year carry-forward provision for any excess, is far from ideal, but it appears to be a reasonable compromise.

Economic Effects of Capital Gains Taxation

Let us now assume that we have decided to impose a tax on capital gains and that we look to the effect of the tax on the economy. It is at this point that we must particularly recall our previous caution about distinguishing between initial and continuing effects of the tax.

We must not lose sight of the fact that any tax is but one aspect of the overall plan of the public sector. Nor can we forget that income or wealth or any other tax base merely provides an index (hopefully an

equitable one) on which to base the allocation of the tax load among individuals. Without involving ourselves in a prolonged discussion of the issues of public finance we may assert that somehow the cost of activities carried on in the public sector must be financed by those within the jurisdiction of the government. This may be done either on the basis of the benefit derived by the taxpayer or his ability to pay. Again, without arguing the relative merits of these two approaches to the division of the tax burden or some compromise between, we may say that the case for taxing capital gains falls largely within the ability area.

Musgrave suggests that the public budget should satisfy three broad objectives: "(1) secure adjustments in the allocation of resources; (2) secure adjustments in the distribution of income and wealth; and (3) secure economic stabilization."¹⁷ We will examine the contribution of the capital gains tax to the overall budget plan under each of the three headings. The discussion will close with an examination of revenue considerations and the problems of administration to which such a tax would be likely to give rise.

Resource Allocation

In discussing the matter of resource allocation we must remember that our concern is more with allocation within the private sector of the economy than with allocation between the private and public sectors. We must examine the effect on two different, though related, flows of

¹⁷ Richard A. Musgrave, The Theory of Public Finance: A Study in Public Economy (New York: McGraw-Hill Book Company, Inc., 1959), p. 5.

funds: that into the stock market and that into risky forms of real (as distinct from financial) investment. Critics of capital gains taxation argue that such taxation may deter persons from providing money for these areas and also from taking out already committed funds.

How does this come about? There is much talk about the so-called "locked-in" effect of the capital gain tax. Persons who have invested funds in some form of asset may, because of reluctance to pay tax on a realized gain, hesitate to sell when other considerations might dictate the prudence of such a move. It must be recognized, of course, that such a problem emerges only when realized rather than accrued gains form the tax base. The asset holder may, it is argued, be deterred either by the loss of net worth or the loss of income which would result from the decrease in capital brought about by the tax.

But is this necessarily bad from an economic standpoint? There are those who feel that it is neither wise nor necessary to provide an incentive for the purchase and sale of existing assets and who thus conclude that capital gains should be taxed fully as income. Richman says:

The purchase of outstanding securities is not investment from the social point of view. . . . In the interest of economic growth, one would like to encourage investment in capital goods, capital formation. Favorable treatment accorded capital gains does create such an incentive, but it hardly appears desirable to extend the privilege to those purchasing existing assets.¹⁸

While encouraging the transfer of existing assets, per se, is perhaps unwise, it seems necessary to provide liquid markets for assets as incentive for persons to invest initially. In addition, Poole states that "a vigorous stock market is necessary in order to encourage present holders of seasoned securities to sell and reinvest the proceeds in securities of promising new and relatively risky undertakings."¹⁹ This seems to be the crux of the matter. It is impossible to say, ipso facto, that an exchange of existing securities has no net effect on the economy without knowing the way in which the seller disposes of the proceeds as compared with the way the purchaser might otherwise have used the funds had he not purchased the security in question. While this latter will be, in many cases, purely a matter of conjecture, the comparison must nonetheless be made before the transaction can be validly appraised.

On balance it seems that even a tax which merely deters transfers of existing assets may well be undesirable. Liquidity in asset markets, particularly securities ones, seems necessary if funds are to flow freely from those who have savings to those who have investment opportunities without the funds necessary to carry them out.

But does a capital gains tax provide such a deterrent effect? To answer this question entirely one would have to examine in some detail investment (and perhaps savings) motivation. Empirical evidence on this point is difficult to compile and little work of this nature appears to

¹⁹ Kenyon F. Poole, Public Finance and Economic Welfare (New York: Rinehart and Company, Inc., 1956), p. 199.

have been done.²⁰

Throughout our discussion we assume that an investor may seek income, capital appreciation, or both. There should be nothing about a tax on capital gains to deter a person from purchasing an asset, even if he is primarily seeking capital gain. Apart from a confiscatory tax, there will always be a net return. The effect of the tax is to lower this return. Assuming that it is meaningful to talk of a "rate of return" when discussing assets yielding primarily capital gain, the critical point comes when the tax reduces the net rate of return below that which a particular investor feels he needs to induce him to invest rather than hold his funds in a more liquid form. However, it is not easy to find this point with any degree of exactness. If the rate of tax is so high as to cause most investors to reach the point at which they decide not to invest, it would seem that a decrease in rate, rather than elimination of the tax, is indicated.

While there thus should be little interference with the decision to invest, a tax on capital gains may have some influence on the choice of investments made. This will be so particularly if the rate on capital gains is lower than that on other income, as is the case in the United States. If one were to draw an indifference map of an investor's choice between income and capital gain in such a situation, he would expect to

²⁰For an attempt to assess mathematically the nature and extent of the locked-in effect see C. C. Holt and J. P. Shelton, "The Implications of the Capital Gains Tax for Investment Decisions," Journal of Finance, XVI (December, 1961), p. 559 and Idem, "The Lock-in Effect of the Capital Gains Tax," National Tax Journal, XV (December, 1962), p. 337.

find that the investor's marginal rate of substitution of capital gain for income would be greater than unity and that it would increase rapidly as successive increments of income placed him in higher and higher marginal tax brackets. If tax rates were identical on the two, one might expect the marginal rate of substitution of capital gain for income to be unity throughout its range as the two would be virtually perfect substitutes.²¹

In determining whether or not to sell an asset, an investor must draw some conclusions regarding the future course of tax rates. If the rate is assumed to remain constant, the amount of the tax becomes, in effect, a fixed selling cost. Thus there should be no disincentive to selling arising from the tax. If market conditions suggest that the asset is unlikely to increase further in price, and that it may well decrease, it will be more profitable to sell then than at any other time in spite of tax considerations, unless the marginal rate of tax on capital gains is 100%. One exception to this might arise under a progressive capital gains tax where a person would, by selling in a particular year, subject himself to a higher marginal rate than if the gain were realized the

²¹ We assume that the investor in question would be subject to a higher marginal tax rate on his regular income than his capital gains. Since Seltzer concluded (p. 128) that there seems to be some correlation between high income and high capital gains this is perhaps not an untypical situation. We neglect, too, the effects of expected risk, in order to observe the pure tax effects on portfolio choice. Since capital appreciation is less likely to materialize than income, the investor would presumably have a less pronounced choice for gain in the first case and would have a positive choice for income in the second. The magnitude of this adjustment would, of course, depend on the degree of risk anticipated.

following year. In such a case, the expected tax saving would have to be carefully balanced against the possibility that before the year end the price of the asset might fall sufficiently to wipe out the saving.

If the tax were expected to change, the situation might be quite different. There would be particular uncertainty about future rates at a time when a capital gains tax was first introduced, as there would then be no background of experience on which to base future expectations. In general, however, if there was a general expectation of tax increases there would be some incentive to sell, although the possibility of further appreciation in the value of the asset might well outweigh the expectation of added tax at the time of realization. Unless the tax increase were expected to be substantial, probably few selling decisions would be affected by such considerations. Similarly, if the rate were expected to fall, investors who had been planning to sell might be prepared to hold. Again the possibility of price decreases must be balanced against the possible tax reduction, and again it seems unlikely that many decisions would change as a result of the expected tax cut.

Thus far our concern has been largely with the investor whose primary goal is capital appreciation. What of the one who seeks income? Here there is a further point to be considered. In the case of gains which result from increased earning prospects or from a fall in the rate of interest, a realization and subsequent payment of tax will mean that the investor has less capital available to invest and his income will thus be reduced. This argument loses some of its appeal, however, when we realize that earning prospects of all assets do not rise and fall

together and that there is no single rate of interest prevailing in the market. It is quite possible that there will be other assets on which the earning potential has risen more than those which the investor is holding. Similarly, there will quite likely be assets on which the rate on interest has fallen less than that on the assets now held. Thus the absorption of some of one's capital by a capital gains tax will not necessarily mean that one's income will be lower after realization than before. There will very likely still be shifts of investment which can be made without loss, and perhaps even with gain, of income.

Another aspect of the locked-in problem, and one to which considerable amount of criticism has been directed for its inclusion in the American tax, is the exemption from capital gains tax of gains embodied in property transferred by gift or bequest. This, it is argued, provides further incentive for the investor to retain his holdings as he may eventually avoid the tax altogether. As this provision is not of necessity a part of capital gains taxation, the criticism is one of the particular provision rather than of the entire tax. Recognizing death or gift as a time of constructive realization would remove much of the problem. It would seem in any event that older persons are the ones most likely to be affected by present provisions. Since such persons are likely to be rather conservative in their investments and business dealings, it would be difficult to ascertain the extent of the tax influence on any decision not to sell a given asset. Moreover, it would seem best to allow younger, more adventuresome investors to use their funds to finance new enterprises rather than to purchase existing securities from older asset-holders.

All in all it seems that a tax on capital gains may discourage some transactions entirely, but it appears that such instances would not be so widespread as many fear. The presence of a tax reduces the profitability of numerous transactions, but the rational investor would probably find, in most cases, that other considerations outweigh the tax consequences. It is not to be inferred from the above discussion that the process of choosing or changing an investment portfolio is a simple task. However, it is a process which is carried out on a large scale every day and it seems that most of the same considerations which guide rational decisions in the absence of the tax would apply in its presence as well.

In the same way that taxation of capital gains is said to discourage sales of assets, the deduction of capital losses for tax purposes is said to encourage sales. While there may be some doubt about the former, the latter seems more certain in its effect.

If we can assume that no one invests with the expectation of realizing a capital loss, capital loss deduction can affect only the sale of assets, not their purchase.

In the absence of a capital gains tax (and loss offset) a market slump which gave evidence of continuing for some time might suggest to the investor that he sell in order to minimize his losses. He has the further possibility that he might be able to repurchase at a slightly lower price. On the other hand, it would seem reasonable to assume that the prudent investor, at what appeared to be the bottom of a market downturn, would be best advised to hold the securities he had at the time in the hope and expectation that their value would rise. We might expect an

investor who is primarily seeking income, to be slightly less sensitive to price changes.

If we assume that there is a tax on realized gains and corresponding loss offset against gains,²² what will be the effect on investor behavior? A person with accrued losses and realized gains will be tempted to realize sufficient of his losses to balance his gains and thereby save paying tax on them. If we assume that his gains and losses are just equal, the taxpayer will be able to recoup part (though not all) of his loss in the form of tax savings. It would be worthwhile to realize a loss and repurchase the same asset subsequently even at a somewhat higher price. The more generous the loss offset provisions, the more incentive there is to realize accrued losses. Expected tax rate changes modify this. The expectation of lower tax rates on capital gains will provide additional incentive to early realization, while the expectation that tax rates will rise makes delay more lucrative. It thus seems that tax considerations may be of considerable influence in the decision to realize losses although the same cannot be said with anything like the same certainty for gains.

With regard to real investment Barbeau states:

It is often alleged that a capital gains tax will reduce capital investment generally and risk investment specifically. The United States' experience certainly does not support the first

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A loss offset such as that presently in use in the United States, or a complete offset of all losses against other income would merely increase the effect.

allegation while the second allegation results perhaps from the fact that capital losses cannot be offset against income.²³

Before we leave the problem of resource allocation under a capital gains tax, we must consider one further, less obvious problem. Where capital gains are taxed at a lower rate than that on other income, or not taxed at all, there will be a considerable amount of time spent by tax lawyers and investors alike devising schemes to minimize tax by framing transactions in such a way as to attract the lower capital gains rates. It is quite likely that a tax system which taxed all income and gains at the same rate would provide a substantial saving in man-hours attributable both to this and to the additional litigation which inevitably arises therefrom. To the extent that men are concerned with tax avoidance schemes or purchases and sales of speculative securities, resources are being poorly allocated.

The effects of capital gains taxation on the distribution of income are not easy to assess. Since gains and losses tend to follow the business cycle, we would expect the majority of gains to arise during boom periods. To the extent that these gains are enjoyed largely by wealthy persons, capital gains taxation undoubtedly adds somewhat to the progressivity of the tax structure generally. Since progressive taxation is intended as a means of securing a more equal distribution of income, such a tax will have distributional effects.

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Canadian Tax Foundation, Report of Proceedings of Sixteenth Annual Tax Conference (Toronto, 1962), p. 82.

Similarly, the majority of losses might be expected in times of recession. If losses, too, are suffered by those in the higher tax brackets, an element of regression is introduced into the tax system. The importance of this regressive element depends on a number of factors. Most important is the nature of the loss offset allowed against ordinary income. If all losses are to be allowed as income offsets, the result is quite likely to be a regressive tax. If there is a limitation on loss offset, the amount of regression decreases.

However, it may well be that the concentration of losses among higher income recipients is not as high as is the concentration of gains in the same group. Since persons with larger incomes and wealth are better able to diversify their investment portfolios, they are more likely to have at least some gains, even during depressed periods. On the other hand, the small investor who is unlikely to be able to purchase more than a few different securities at a time may be harder hit by market downturns. Seltzer's research seems to bear out the fact that losses seem more concentrated in lower or middle income groups while gains are concentrated in middle or upper income groups.²⁴

The taxation of realized gains only would further cloud the picture, as the timing of realization of gains or losses need not coincide with the swings of the business cycle. It would be difficult to say how much effect this factor would have on any progressive or regressive tendencies produced by a capital gains tax.

²⁴ Seltzer, op. cit., pp. 122-131.

The use of progressive taxation to provide a more equal income distribution seems to presuppose a value judgment that the present unequal distribution of income is undesirable. However, there is by no means universal agreement on this latter point. Indeed, Ilersic goes so far as to suggest that "the present exemption from tax of capital gains might even serve to offset any undesirable economic or social effects that an unduly rapid redistribution of wealth may exert."²⁵

Whether or not redistribution is desirable, it seems safe to assert that the capital gains tax has some redistributive effect. The nature and extent of this effect depend partly on the particular phase of the business cycle under consideration and partly on the specific provisions of the tax.

The imposition of a capital gains tax produces other complicating factors which must also be considered. Much depends on what other changes are made coincident with the introduction of the tax. If such a tax is merely an addition to an otherwise unchanged tax structure, it will be necessary to examine the distributional effects of the gain (or loss) of government revenue which ensues. If, on the other hand, the capital gains tax is replacing some other form of government revenue, the distributional effects of the loss of the other revenue source will enter the picture.

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A. R. Ilersic, The Taxation of Capital Gains (London: Staples Press, 1962), p. 17.

Economic Stability

There are two aspects to consider when examining the effects of capital gains taxation on economic stability. We first must look at the effect of the tax collection itself and then look at the effect of the tax on the stability of asset prices.

We noted earlier that capital gains and losses tend to follow the business cycle. Thus, collections from a tax on gains would be expected to be highest during a boom period and lowest during a recession. In the latter period we would also expect a large number of losses and loss offsets would reduce tax collections still further. Prest concludes; "All-in-all, we may say that an income tax impinging on capital gains as well as other income will probably, though not decisively, have better counter-cyclical properties than an equal revenue income tax which does not include capital gains."²⁶

To the extent that averaging of gains is allowed, this counter-cyclical effect will be reduced somewhat. Further complications arise with the use of monetary policy to correct cyclical swings. A tight money policy in a boom will force the prices of interest-bearing assets down and thus reduce tax collections, while an easy money policy in a recession will force prices of such assets up, and thereby increase taxes. This, of course, counteracts the counter-cyclical effect of the tax itself.

²⁶ A. R. Prest, Public Finance in Theory and Practice (London: Weidenfeld and Nicholson, 1960), p. 297.

Most writers agree that a capital gains tax will have some destabilizing effect on market prices of assets, although there seems little agreement as to the exact nature and extent of the disturbances created. It is argued that in a period of rising prices the locked-in effect of the tax reduces the supply of assets offered for sale and this drives prices up even further. When prices are falling, there will be many persons seeking to realize deductible losses, thereby driving prices down further than would otherwise be the case. The latter will be most severe when full loss offset is allowed against other income. The supply will be decreased more than demand in an upswing, it is claimed, and will be increased more than demand in a downswing.²⁷

On the basis of our earlier analysis, it seems that (at least in the former case) the tax effects have been somewhat exaggerated and thus that the supply curve would not move as far as is suggested. During a downswing there may be much of the effect suggested, but again if losses may be offset only against gains, the effect is likely to be minimized.

Moreover, Richman argues²⁸ that since many securities are virtually perfect substitutes for one another, the demand curve will be almost perfectly elastic and thus even a substantial fall in supply will produce little change in the price.

Hence, we must examine the effect on the demand curve. Here there

²⁷ For a more complete discussion of this analysis see Harold M. Somers, "Reconsideration of the Capital Gains Tax," National Tax Journal, XII (December, 1960), p. 289.

²⁸ Richman, op. cit.

are two points to consider. First, there is the contention that investors are likely to reinvest the proceeds of any sale. If they are locked into their initial investment, the overall demand for securities will be reduced accordingly. But even if they do choose to realize, the effective demand will be reduced by the amount of the tax. Groves goes so far as to suggest that the demand will be reduced by more than the supply.²⁹ It thus seems that the tax may have some destabilizing effects on asset prices, but such effects seem to have been somewhat exaggerated by many opponents of the tax.

Revenue and Administrative Considerations

Critics often claim that a capital gains tax yields no net revenue over a period of years. They contend that, over time, gains and losses tend to equal one another. American experience has shown a positive net revenue, but again it is argued that this results from less-than-complete loss allowances, and that, had losses been allowed fully, net revenue would have been zero. Considering the long-term upward trend of stock prices in Canada and the United States over the past several decades, this view is open to question. Even if gains and losses were to balance one another over time, there is no reason why this should mean that there would be no net revenue over the period. To the extent that gains and high income occur together in a period of prosperity, taxpayers will be faced with high marginal tax rates. Indeed, gains themselves often raise taxpayers into

²⁹Groves, op. cit.

higher brackets than otherwise would be the case. On the other hand, in depressed periods when losses are more frequent and other income may be lower, tax savings will be at lower marginal rates. A gain of given size one year may be taxed at 50%, while a loss of the same size the following year may yield a tax saving of 40%. While gains balance losses, there is a net revenue to the government.

Numerous administrative problems are created by the tax. We have already noted the problems of asset valuation involved and, while they would not be as great if realized gains only were being taxed, they would still be considerable. All assets would still have to be assigned initial values. From then on, much of the burden would be placed on the individual taxpayer, who would be required to maintain accurate, long-term records. The personnel required to value all assets would be extremely large, unless the job were to be spread over a number of months or years.

Perhaps even greater than the assessment problems would be those of detection and compliance. To the extent that some taxpayers were able to conceal some of their assets, they would be able to avoid paying their fair share of the tax burden. This avenue of tax avoidance would exist not only initially, but also subsequent to the imposition of the tax. Although the valuation of assets purchased while the tax was in effect would be relatively simple, the detection of all transactions would be difficult.

Thus it can be seen that the problems involved in taxing capital gains, or even in deciding whether or not to tax them, are considerable and not easy to resolve. Yet if Canadian officials were to impose such a tax, as some have suggested they do, they would first have to attempt to find solutions to many of these problems before proceeding further.

CHAPTER V

CONCLUSIONS

Our final task is to determine the present tax status of capital gains in Canada and to ascertain whether any changes seem necessary.

Problems Under Present Treatment

One cannot help but conclude that there is much uncertainty regarding the whole area of capital gains under the Canadian tax structure. This uncertainty stems from at least three sources, the Income Tax Act, the assessment policies of revenue officials and the courts. Let us look briefly at each in order to determine the extent to which they contribute to the entire situation.

Since capital gain is not separately defined in the Income Tax Act, it is apparent that it is merely a residual concept. It includes anything not falling with the meaning of income. Thus the income definition assumes a position of crucial importance. We noted earlier, however, that this latter definition was extremely vague and unclear. The Act, then, cannot be relied upon to provide any sort of precise idea as to the nature either of income or capital gain. Thus the charging section of the Act is open to a number of possible interpretations. Whether the interpretation chosen by the taxpayer will agree with the one taken by either the Department of National Revenue or the courts is another matter.

The role of departmental assessment policy in the capital gains problem seems to have been largely overlooked in Canada in recent years.¹ Yet a change in this policy could have a profound effect on the whole problem at hand. It must be remembered that most of the disputes which come before the Tax Appeal Board or the courts arise only if the Department of National Revenue disagrees with the taxpayer's interpretation of the meaning of income.

However, the Department has neither unlimited staff nor endless resources at its disposal, and it is thus unable to check all returns. Even among the discrepancies which the Department discovers (either from tax returns or in other ways) they must choose those which are to be assessed. Since the taxpayer is likely to appeal any assessment made, there must be sufficient evidence available to make a reasonable case before the Board, and the Department must have the legal staff necessary to argue all the cases which arise. The cost involved may well outweigh the additional revenue gained.

One area which has been particularly neglected by the Department is that of gains from stock market transactions. It seems probable that the practical difficulties involved in assessing the large number of such gains from this source occurring annually have deterred officials from assessing them. Barbeau suggests² that there may, in fact, be a delib-

¹Jacques Barbeau provided an exception when he gave the matter particular stress at the 1962 Conference of the Canadian Tax Foundation. See Canadian Tax Foundation, Report of Proceedings of Sixteenth Annual Tax Conference (Toronto, 1962), p. 76.

²Ibid.

erate policy against taxing such gains. Real estate profit is usually both a more obvious and lucrative target for taxation, and it is in this area that we find most of the Department's efforts being made.

It is interesting to note that it is in the McConnell case,³ one of the few in which a profit on a sale of shares has been taxed, that we find these words:

Likely, many . . . ventures elude notice and thus escape the incidence of income tax. When, however, as happened here, the details of such a transaction chance to come to light, the relevant provisions of the Income Tax Act come into play and rarely and only in special circumstances revealed by the facts of the matter, may the taxpayer concerned expect to avoid taxation in respect of the gain made.⁴

But what of the assessments which eventually come before the Tax Appeal Board and the courts? Do the judgments provide any more certainty? At the 1962 Conference of the Canadian Tax Foundation, Stanley E. Edwards had this to say:

In Canada the statute law on the subject of capital gains is very simple, bordering on the non-existent. However, the judge-made law is complex, bordering on the confusing.⁵

The truth of this last sentence should be evident from the discussion of cases in the third chapter. The use of the tests set out in the Taylor case⁶ as a sort of framework for the discussion proved to be far from satisfactory. This was so not because the tests are inapplicable,

³ 60 DTC 173.

⁴ Ibid., p. 175.

⁵ Canadian Tax Foundation, op. cit., p. 87.

⁶ 56 DTC 1125.

but rather because few cases fall into a single category. In all of the cases, the unique circumstances present determine the result; in most of them, the court relies on several of the tests in order to reach its decision. While it is probably safe to conclude that the profit from a transaction possessing only one hallmark of income will not be taxed, the same cannot be said about a transaction possessing two or even three attributes of income. Nowhere is there any objective test as to the number of such attributes necessary to render a profit taxable, nor is it likely that a universally acceptable one will (or can) ever be devised.

Moreover, the tests set out by Mr. President Thorson are not exhaustive. For example, the frequency with which gains occur is often of importance. Although this is related to recurrence, it is an ex post concept, while the traditional view of recurrence was an ex ante one. The likelihood of recurrence was the important consideration in early British and Canadian law. Secondary intention is another test which has arisen since 1956.

The appearance of the latter doctrine, and the decision in the Drumheller case,⁷ provide evidence of the widening scope that is being given to the meaning of income in Canada. This trend is noted by Barbeau with some alarm as he suggests⁸ that if action regarding the taxation of capital gains is not taken soon, there will be no gains left to tax.

⁷ 59 DTC 1177.

⁸ Canadian Tax Foundation, op. cit.

Shinder, on the other hand, claims⁹ that capital gains are a vanishing phenomenon in Canada and that the courts are merely reflecting this fact in their decisions.

Some Possible Changes

What can be done to ease this three-sided confusion? It seems evident that it is not possible to solve one aspect of the problem without having an effect on the other two. Thus, changes must be made, if at all, in all three simultaneously.

What changes are necessary? The statutory definition should be made clearer so that the courts would have a more certain guide on which to base decisions. Yet the definition must be such as to simplify problems of assessment by the Department. Such a combination seems difficult to attain, and the result would probably have to be a compromise between the two.

More effort and probably a larger staff for the Department would be necessary in order to handle the added problems of detection and enforcement.

Finally, the courts, on the basis of a more precise statutory guide and more comprehensive coverage of transactions would have to strive for more consistency in their judgments. The goal should not be

⁹ B. B. Shinder, "The Taxability of Capital Gains in Canada," Faculty of Law Review, University of Toronto, XIX (April, 1961), p. 87.

a perfectly rigid law, but rather one which carries with it considerably more precision than is presently the case.

Before any of these details can be worked out, however, there needs to be a policy established so that the practical considerations may have a sound theoretical base on which to rest. It must be decided whether the present trend of an ever-widening income definition is to continue, or whether it should be stopped, or even reversed. If capital gains are to be specifically taxed, the problems discussed in the preceding chapter must be faced. But as long as some distinction is to be made between gains and income, a clear concept of capital gains will be required.

It is at this point that the economist should be in a position to assist the lawmakers. However, as we have seen, it is not easy either to define capital gain or to determine whether gains should be taxed. There is little agreement among economists on either of these matters, and few are prepared to take sides. It is left to the lawyers, accountants and businessmen to determine what should be done, but even these men, arguing from essentially practical grounds, cannot agree. While more work should be done by economists in examining the economic nature of capital gains, it is possible that there will never be universal agreement on more than a small core area of definition.

This does not mean that nothing should be done. The fact remains that the uncertainty provided by the present Act needs to be lessened. The definition of income (and capital gain) can be tightened considerably even without a universally-accepted economic definition of capital gain.

But this can be no more than a stop-gap measure. At some point Canadian lawmakers will be faced with a choice between a specific, and perhaps arbitrary and inequitable definition, and one which is more general and subject to a considerable amount of interpretation by the courts. If it is thought that certainty is the prime value to be sought, the legislators will presumably choose the former. If they feel that considerations of equity are more important, the latter will undoubtedly be their choice.

While there is no guarantee that sound theory can be translated into realistic practical terms, it is certain that without sound theory, there can be no sound practice. The goal, then, should be to achieve agreement on the generally accepted meaning for capital gains with the indefinable fringe being left to judicial interpretation. Once this has been done, capital gains will occupy a clear and definite place in the Canadian income tax structure.

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